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Study: EU-CEE countries need an industrial policy for a new growth model

- *EU members in Central Eastern Europe must build globally competitive companies*
- *The state has a role to play in promoting industrial strengths*
- *East Asia's success stories can provide inspiration*

Since the early 2000s, the EU member states of Central and Eastern Europe (EU-CEE) have achieved impressive economic catch-up. However, the previously successful model of taking over labour-intensive production steps as an 'extended workbench' of Western corporations has reached its limits. Combined with major structural changes such as decarbonisation and digitalisation, this means that a new, innovation-based economic model is necessary. *'Only then will these states be able to catch up with Western Europe in terms of productivity and living standards,'* says Zuzana Zavarská, an economist at the Vienna Institute for International Economic Studies (wiiw) and co-author of a new study on the topic.

The basic problem is that the central technological skills and those parts of production with the highest value added are both located in the 'headquarter economies' of Western Europe. On the other hand, the EU members of Central Eastern Europe (i.e. Poland, Czechia, Slovakia, Hungary, Slovenia, Croatia, Romania, Bulgaria and the Baltic states) continue to specialise in labour-intensive production. They stand and fall on low labour costs. This limits their prospects of catching up economically with Western Europe.

Dominant automotive industry

A good example is the car industry, which is so important to the region, given its large share of value added, jobs and exports, especially in the Visegrád countries, Romania and Slovenia. The heavy dependence on it could yet become a problem for some countries. *'It is well known that the production of electric cars is much less labour intensive than that of conventional models with combustion engines. Then there is also the advancing automation in industry, which will exert economic pressure on those countries,'* explains Zavarská.

In a new study commissioned by the Friedrich-Ebert-Stiftung (FES), wiiw has therefore examined how a tailor-made industrial policy could help the states of the region escape this 'middle income trap'. To this end, the study's authors first analysed the status quo, before going on to suggest alternative development options. The main finding: the states of Central Eastern Europe could learn from the experiences of the East Asian tiger economies.

East Asia's success stories

'Taiwan and South Korea have shown how effective a well-designed strategic industrial policy can be. Even though there are many differences with the EU members of Central Eastern Europe the success

stories of East Asia offer valuable inspiration,' emphasises Zavarská. Like the role models of East Asia, the EU-CEE countries have always been players in the manufacturing sector and have a strong industrial base. The integration of the East Asian economies into global value chains via multinational corporations has given them an opportunity to benefit from the transfer of advanced technologies.

In East Asia, Singapore, for example, has been very successful in attracting foreign direct investment in areas that match the country's industrial potential and development goals. Formulating a strategic vision for targeted specialisations is another lesson EU-CEE could learn from East Asia. In addition, the gains in prosperity should be distributed as evenly as possible, in order to ensure the support of the population in the transformation process.

EU membership as an opportunity

For the Central Eastern Europeans, their EU membership offers many opportunities, even if it also imposes certain limitations. On the plus side, there is access to funding, participation in research networks and the opportunity to help shape industrial policy at the EU level. Public support for strategic industries has gained enormously in importance in the EU in recent years – one need only think of initiatives such as the European Chips Act or the Important Projects of Common European Interest (IPCEI). *'This also creates momentum for EU-CEE countries to develop their own industrial policies,'* says Zavarská. On the other hand, the strict EU rules on state aid and an EU competition policy that is almost exclusively committed to free market principles pose a challenge.

Towards the entrepreneurial state

Even though the creation of a true 'entrepreneurial state' along the lines of East Asia is likely to be unrealistic for most EU-CEE countries in the coming years, the study recommends steps in this direction, including the following measures:

1. A national innovation system should be created in each country to link the private sector, universities, key ministries and business agencies. Within this environment, new ideas can be developed, tested and funded.

2. The EU-CEE countries should make full use of the available EU funds and should participate to the greatest extent possible in EU research initiatives, in order to drive their own industrial policies. Governments should also get more involved in industrial policy debates at the EU level.

3. The countries should learn from the successes of others in digitalisation: Estonia is generally regarded as a model here. But there are also other positive examples in the region: Romania and Croatia have a particularly high proportion of graduates in computer science; Czechia serves as a beacon with its digital start-ups; and the Baltic states are distinguished for the quality of their digital public services. The Visegrád countries and Slovenia have highly digitalised and automated industries.

4. Instead of providing blanket support for all investments by foreign companies, national governments should think strategically about which sectors and parts of the value chain they would like to attract to the country. Incentives should also be created to maximise the transfer of knowledge and know-how from foreign corporations to domestic ones.

5. Promising niches should be identified and exploited: each country has its traditional strengths that can be built upon.

6. Institutional reforms should be undertaken: in some states in the region, the quality of public institutions has declined significantly in recent years. This is worrying. The experience of East Asian nations in building adequate institutions should be utilised.

7. Structural change must be cushioned socially, in order not to lose the support of the population. In order to facilitate the transition from old to new industries, the EU-CEE countries should follow the Scandinavian model of a flexible labour market combined with a strong welfare state.

8. A tailor-made industrial strategy is required for each country. While the Baltic countries, for example, are well positioned for the digital transformation, they are struggling particularly with distribution problems and a shrinking population. Czechia, Poland and Slovenia are the most developed industrially, but they must each make the transition from an 'extended workbench' to an innovative national economy. The less-developed countries of the region, such as Bulgaria and Romania, should rely primarily on the transfer of know-how and innovation by foreign investors.

The full study is available for download here.

About the Vienna Institute for International Economic Studies (wiiw)

For 50 years, wiiw has been an economic think tank that produces economic analyses and forecasts for currently 23 countries in Central, Eastern and South-Eastern Europe. In addition, wiiw conducts research in the areas of macroeconomics, trade, competitiveness, investment, the European integration process, regional development, labour markets, migration and income distribution. www.wiiw.ac.at

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